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## **The Relationship Between Monetary and Fiscal Authorities: A Survey of the Issues**

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## 1. Introduction

Fiscal policy and monetary policy are the two cornerstones of macroeconomic policy, aimed at creating macroeconomic stability and economic growth. While both policies have common objectives, the instruments used differ. Fiscal policy relies upon instruments such as government expenditure, taxes and borrowing. Monetary policy influences the level of economic activity through actions that influence the overall liquidity in the economy. Effective macroeconomic management presupposes a coordinated fiscal and monetary policy framework with a clear division of responsibilities and instruments, since fiscal policy has a strong impact on the conduct of monetary policy. The objectives of the fiscal authority can only be achieved by the use of fiscal instruments, without subordinating monetary policy to fiscal objectives. The monetary financing of a high fiscal deficit and government borrowing at below market-determined interest rates significantly affect the effective functioning of monetary policy and lead ultimately to the build-up of inflationary pressure in the economy. Conversely, when fiscal policy is sustainable and financed in a non-inflationary way, monetary policy can be conducted to deliver a stable price level and a reduction in output fluctuations.

Since the activities of the fiscal authority can thus place constraints on the effectiveness of monetary policy, this paper reviews some institutional arrangements that provide the central bank with a substantial degree of freedom to formulate and implement monetary policy in pursuit of its policy target(s), i.e. instrument independence.

In order to ensure a coordinated and consistent policy framework by the respective authorities, several concrete fiscal/monetary policy interfaces have to be addressed. These relate to:

1. Direct credit to the government
2. Indirect credit to the government
3. Quasi-fiscal activities of the central bank
4. Exchange rate regime.

## 2. Direct credit to the government

It is a widely accepted consensus that the best possible way monetary policy can contribute to the growth of employment and economic activity is through the pursuit of a stable price level. However, in conducting monetary policy effectively towards this final objective, central banks in many transition countries were repeatedly subordinated to fiscal financing decisions in the past, leaving little room for an effective stabilisation policy. This is evident in past episodes of chronic inflation and an extreme volatility of output.

Because both monetary and fiscal policies are intrinsically linked through the budget constraint of the government, a sound monetary policy, and hence a country's inflation performance, are dependent on the stance of its fiscal policy. The government can finance a budget deficit either by increasing foreign or domestic debt, or by monetary deficit financing by the central bank. When the deficit is financed by direct central bank credit (e.g. central bank loans or central bank purchases of government debt in form of bonds), it results in increasing the monetary base (reserve money) and a proportional increase in broad money (given a constant money multiplier). In order to study the potential harmful effects of such deficit financing, a distinction should be made according to the time horizon of such direct central bank credit, i.e. whether it is granted on a permanent or a temporary basis.

### Permanent credit to the government

Since this procedure significantly reduces the ability of the central bank to conduct independent monetary policy, many industrial countries have *legally prohibited* or at least *severely limited* direct central bank credit to the government on a permanent basis to avoid a potential loss of monetary control. In emerging market economies (in particular countries in transition), direct lending to the government continued to be more widespread. Narrow and underdeveloped domestic financial markets and limited access to external financing inevitably lead to monetary deficit financing, at least at the initial stage of the transformation process. However, an open-ended access to credit facilities at the central bank no longer exists: in the major emerging market economies limits are imposed on the amount, maturity, purpose or frequency of recourse to central bank credit either by the respective central bank legislation or by the na-

tional constitution (see the second and third column of Table A in the Annex; further evidence is presented by BIS [1999] and JACOME H. [2001]).

There can be cases, e.g. when state-owned commercial banks are involved, where the above mentioned prohibition of granting credit to the government can be by-passed. If such banks provide credit to the government while simultaneously obtaining reserves from the central bank, the control of the development of the monetary base loosens. Therefore, judged by its similar effects on the operational independence of the central bank, such cases of credit to the government via the banking system should be treated the same way as direct credit to the government and prohibited or at least strictly limited.

As far as the monetary consequences of fiscal deficit financing are concerned, no distinction between central bank credit in form of bonds or loans (i.e. marketable or non-marketable debt) is normally made. However, differences between these forms do exist. It is regarded less harmful if credit is granted through the acquisition of bonds since it provides the central bank with a stock of government bonds, increasing thereby the flexibility of the implementation of monetary policy.

### Temporary credit to the government

An exception from the legal prohibition of direct central bank credit to the government is in reality frequently found with the provision of short-term loans to the government which are exclusively devoted to the purpose of bridging temporary mismatches in receipts and payments in the budget. However, the granting of such liquidity loans to the government for bridging short-term liquidity difficulties should follow strict conditions regarding the nature, maximum amount, and time horizon of such financing. Table 1 provides an overview of such institutional features for 5 Central and Eastern European countries (see also the first column of Table A in the Annex for further evidence).

Since a credible facility with the above mentioned institutional features is only a mechanism to cover day-to-day mismatches in receipts and payments of the government, it must not be regarded as a permanent source of financing for the budget deficit. Such problems could only arise when this short-term credit to the central government turns into a practice of rolling over this facility, again resulting in automatic monetisation of the government's deficit. Therefore, the use of such a facility will have to be periodically suspended. Furthermore, it is important to charge a market-related interest rate on any balances outstanding.

**Table 1. Limits to direct credit to government  
in 5 Central and Eastern European Countries**

|               | Czech Republic  | Hungary   | Poland  | Slovakia  | Slovenia   |
|---------------|---|---|---|---|--|
| Direct credit | <ul style="list-style-type: none"> <li>• Purchase of short-term (3 month) Treasury bills permitted</li> <li>• Maximum: 5% of previous year's state budget revenues</li> </ul> | <ul style="list-style-type: none"> <li>• Short-term liquidity loans to bridge temporary difficulties permitted</li> <li>• Maximum: 2% of planned budget revenues</li> </ul> | <ul style="list-style-type: none"> <li>• Purchase of government securities on the primary market permitted</li> <li>• Maximum: 2% of the planned state budget expenditures</li> </ul> | <ul style="list-style-type: none"> <li>• Purchase of short-term (3 month) Treasury bills to cover fluctuations in the state budget permitted</li> <li>• Maximum: 5% of state budget revenue of previous year</li> </ul> | <ul style="list-style-type: none"> <li>• Short-term loans to bridge temporary imbalances in the budget permitted</li> <li>• Maximum: 5% of budget of current year and not more than 20% of anticipated budget deficit</li> </ul> |

Source: RADZYNER AND RIESINGER [1997], p.69

**Proposal 1: Due to its inflationary consequences, direct credit to the government should be legally prohibited or at least severely limited. The design of (temporary) liquidity loans has to obey strict constraints which ensure the credible use of such an instrument.**

### **3. Indirect credit to the government**

Contrary to the acquisition of government securities in the primary market, the acquisition of such securities by the central bank on the secondary market, where government debt trades along with private sector securities at market-determined interest rates (indirect credit to the government)– is permitted by the majority of advanced countries central banks. However,

most of these countries established safeguard clauses which limit this kind of transaction to operations conducted for monetary policy purposes. The following Table 2 gives an overview for 5 Central and Eastern European Countries (for further evidence on selected emerging markets, see the last column of Table A in the Annex).

**Table 2. Limits to indirect credit to government  
in 5 Central and Eastern European Countries**

|                 | Czech Republic  | Hungary   | Poland  | Slovakia  | Slovenia  |
|-----------------|---|---|---|---|---|
| Indirect credit | <ul style="list-style-type: none"> <li>• In order to regulate the money market the bank can buy and sell negotiable securities</li> </ul> | <ul style="list-style-type: none"> <li>• The bank enters into security transactions with repurchase agreements</li> </ul> | <ul style="list-style-type: none"> <li>• No provisions concerning the secondary market</li> </ul> | <ul style="list-style-type: none"> <li>• Bank may purchase and sell negotiable securities for the purpose of regulating the money market</li> </ul> | <ul style="list-style-type: none"> <li>• The bank regulates the amount of money by purchasing and selling state securities</li> </ul> |

Source: RADZYNER AND RIESINGER [1997], p.69

The three main types of monetary policy instruments used by most central banks are open market transactions (in the form of outright purchases/sales of bonds and repo operations), standing credit facilities (e.g. discount and lombard facilities), and reserve requirements. Broad use of open market transactions, both in the form of outright or repo operations, is greatly facilitated by the presence of developed markets for high-quality, liquid debt securities. Often, this involves short-term paper issued by the central government (usually Treasury bills) with no credit risk. However, there are cases where central banks have issued substantial amounts of their own securities (see HAWKINS [2004] for a detailed overview). This took place in situations where government securities were not available or not suitable for this purpose, e.g. due to an underdeveloped market in government papers. The crucial advantage of using only its own securities for monetary policy purposes is that by not needing to hold government securities the central bank may avoid the temptation of (indirectly) lending to the government, thereby increasing its independence from the fiscal authority. This can further clarify the distinction between monetary and fiscal management functions (HAWKINS [2004], p. 7).

**Proposal 2: Purchases of government bonds in the secondary markets for the sole purpose of conducting monetary policy are generally permitted. However, using central bank securities for this purpose could be preferable, since this shields the central bank from indirect lending to the government completely.**

#### **4. Quasi-fiscal activities of the central bank**

It was stated in the first section, that in many countries central bank laws emphasize the operational independence of the central bank and prohibit or restrict its direct financing of the fiscal deficit.

In some countries, however, in order to ease budget pressures, a number of activities carried out by central banks are quasi-fiscal in nature. These activities may potentially threaten the proper conduct of monetary policy, which is the primary responsibility of the central bank. In general, quasi-fiscal activities (QFA henceforth) may be conducted by the central bank, public financial institutions, and nonfinancial public enterprises. This is a particularly frequent phenomenon in transition countries, where officially recorded budget accounts do not necessarily reflect the overall public sector balance. Such operations may be used by governments as a substitute for direct fiscal measures, and will have similar economic effects in whichever part of the public sector they are conducted (IMF [2001], p.13). It is difficult to precisely identify and quantify QFA by central banks, but they may involve operations related to the management of the financial system (e.g., subsidized lending at below market-rates and directed credit) or the exchange system (e.g., multiple exchange rates and import deposits). Typically, subsidized lending to financial institutions or enterprises is extended at the request of the government or parliament. The difference between the interest rates on such loans and the prevailing market-rates is essentially a subsidy, i.e. a QFA by the central bank. Table 3 presents a listing of different types of QFA.

**Table 3. Types of quasi-fiscal activity**

|   |
|---|
| <b>Operations related to the financial system</b>             |
| Subsidized lending  |
| Administered lending rates                                    |
| Preferential rediscounting practices                          |
| Poorly secured and subpar loans                               |
| Loan guarantees   |
| Underremunerated reserve requirements                         |
| Credit ceilings   |
| Rescue operations   |
| <b>Operations related to the exchange system</b>              |
| Multiple exchange rates                                       |
| Import deposits   |
| Deposits on foreign asset purchases                           |
| Exchange rate guarantees                                      |
| Subsidized exchange risk insurance                            |
| <b>Operations related to the commercial enterprise sector</b> |
| Charging less than commercial prices                          |
| Provision of noncommercial services (e.g., social services)   |
| Pricing for budget revenue purposes                           |
| Paying above commercial prices to suppliers                   |

Source: IMF [2001], p.29

Apart from the general negative evaluation of QFA that tend to cause distortions in financial markets, thereby leading to a misallocation of resources, the involvement of the central bank in such activities poses some further threats for macroeconomic stability. The government's call on the central bank to undertake a variety of QFA exposes the central bank to an increase in the probability of negative cash-flows from these operations jeopardizing monetary policy designed to maintain price stability. Under such circumstances, the ability of the central bank to meet its monetary objectives will depend on its ability to maintain an adequate amount of capital to deal with possible losses, or to avoid involvement in potentially costly quasi-fiscal activities, or both.

**Proposal 3: Central banks should not handle quasi-fiscal activities which deteriorate their financial position, leading to a loss of control over monetary policy instruments. The government must ensure at any time the central bank's capital integrity in order to support policy independence.**

## **5. Exchange rate regime**

The previous sections reviewed certain institutional arrangements for the implementation of monetary policy that attempt to insulate the monetary authority from financing requirements of the fiscal authority. While these arrangements are absolutely necessary for the conduct of an independent monetary policy, they are not sufficient. Of particular importance in this respect is the choice of the exchange rate regime, which has a considerable impact on the degree of autonomy in the use of monetary policy instruments.

In practice, most governments (in some cases jointly with the central bank) determine the exchange rate regime. In case of a fixed rate regime (in its different versions), the central bank is normally required to defend the parity by means of intervention in the foreign exchange market. This has implications for the quantity of the monetary base, which in the case of non-sterilised interventions moves one-by-one with movements in net foreign assets. Central banks

regularly try to shield the monetary base from these movements by sterilising their interventions, leaving the monetary base unchanged, but this procedure can reach its limits. The point here to note is that the chosen exchange rate regime can affect the independent operation of monetary policy matters. For example, the government may set an exchange rate target (or band) which is inconsistent with economic fundamentals and the monetary policy settings required to meet the policy objectives of the central bank. A likely result of such a policy is that the central bank suffers large losses following massive intervention in the foreign exchange market in case the parity cannot be defended.

**Proposal 4: Given the close link between exchange rate and monetary policy, conflicts can arise between defending an exchange rate target and domestic monetary policy objectives. In such a case of policy conflicts, priority should be given to the central bank to pursue its own monetary policy objectives.**

R.K.

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## Annex

**Table A: Government funding by central banks**

| Government funding by central banks |                                   |                                    |                                     |                                       |
|-------------------------------------|-----------------------------------|------------------------------------|-------------------------------------|---------------------------------------|
|                                     | Liquidity Loans                   | Direct Loans                       | Purchase of bonds in primary market | Purchase of bonds in secondary market |
| China                               | Prohibited by law                 | Prohibited by law                  | Prohibited by law                   | Allowed                               |
| India                               | Limited, bank rate +2%            | Short-term                         | Allowed                             | Allowed                               |
| Indonesia                           | Prohibited by law                 | Prohibited by law                  | Prohibited                          | Allowed                               |
| Korea                               | Allowed                           | Limited amounts at rates set by CB | Allowed                             | Allowed                               |
| Malaysia                            | Allowed                           | Limited amounts for short term     | Allowed                             | Allowed                               |
| Brazil                              | Prohibited by cons                | Prohibited by cons                 | Prohibited                          | Allowed                               |
| Chile                               | Prohibited by cons                | Prohibited by cons                 | Prohibited by cons                  | Prohibited by cons                    |
| Mexico                              | Mandatory, limited at market rate | Prohibited by law                  | Prohibited by law                   | Allowed                               |
| Peru                                | Prohibited by cons                | Prohibited by cons                 | Prohibited by cons                  | Limited                               |
| Czech Republic                      | Limited by law                    | Limited by law                     | Limited amount                      | Only short-term                       |
| Hungary                             | Prohibited by law                 | Prohibited by law                  | Limited amount                      | Limited amount                        |
| Russia                              | Prohibited by law                 | Prohibited by law                  | Prohibited by law                   |                                       |
| Israel                              |                                   | Limited amounts for short term     | Prohibited                          | Allowed                               |
| Turkey                              | Prohibited by law                 | Prohibited by law                  | Prohibited by law                   | Allowed                               |
| Canada                              | Limited amount                    | Limited amount at market rates     | Allowed                             | Allowed                               |
| Euro area                           | Prohibited by law                 | Prohibited by law                  | Prohibited by law                   | Allowed                               |
| Japan                               | Prohibited by law                 | Limited amount                     | Allowed                             | Allowed                               |
| United Kingdom                      | Limited                           | Prohibited by MT                   | Prohibited by MT                    | Allowed                               |
| United States                       | Prohibited by law                 | Prohibited by law                  | Prohibited by law                   | Allowed                               |

Note: Cons = constitution; CB = central bank; MT = Maastricht Treaty.

Source: BIS [2003], p.79